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Turner, John A.

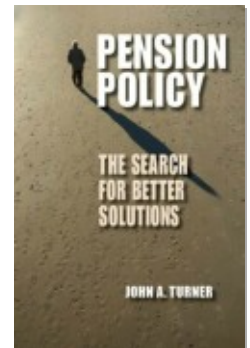
Published by W.E. Upjohn Institute

Turner, John A.

Pension Policy: The Search for Better Solutions.

First ed. W.E. Upjohn Institute, 2009.

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Extending Pension Coverage

Roughly half of U.S. private sector workers are not covered by a pension. Policymakers have long struggled with the question of how pension coverage can be expanded within a voluntary pension system. The United States has instituted numerous pension policy innovations over the past several decades, including, notably, 401(k) plans. Raising pension coverage has been a policy goal over this period. Pension coverage, however, has remained stagnant at roughly 50 percent of private sector workers for full-time employees (BLS 2003). Frustration over the failure of pension policy to increase coverage has raised the question of what we can learn from countries with considerably higher pension coverage rates.

A worker is covered by a pension when the worker is eligible to participate in a plan offered by his or her employer. The term coverage traditionally has also been used to refer to pension participation because in defined benefit plans, but not defined contribution plans, the two are equivalent. Pension participation is the ultimate goal, and it occurs when the worker is accruing future benefits in the plan. While most of this book focuses on workers who are pension participants, this chapter examines reasons why roughly half of full-time workers are not pension participants.

Countries with well-developed pension systems use a considerable variety of policies to increase pension coverage rates. While the United States relies on voluntary provision by employers and uses tax incentives for motivation, that approach does not lead to high coverage rates. As a result, other countries, such as Australia and Switzerland, have mandated that employers provide occupational pensions, as discussed in the previous chapter. Still other countries, such as the Netherlands and Sweden, have widespread pension coverage because labor unions have a pervasive role in their labor markets. This chapter focuses on pension policy to extend coverage and participation within a voluntary pension system.

MEASURES OF COVERAGE

The goal of pension coverage is to provide income for families in retirement. The traditional measure of coverage is the percentage of workers participating in a pension plan at a particular point in time. Other measures, however, may better indicate the extent to which the goal is being met.

Family Rather Than Individual Coverage Rates

While pension coverage is traditionally measured as the percentage of workers eligible to participate in a pension, this approach is not consistent with the emphasis in public policy on the family or household as the economic unit. Coverage rates are higher for families or households than they are for individuals because the family would be considered as covered if one member had pension coverage. Over time, changes in family structure affect coverage rates. For example, when considering the coverage of women, the coverage rate is higher using a family measure than a worker measure. However, with increasing divorce rates and women increasingly living without a spouse, those changes reduce women's coverage rates over time (Even and Turner 1999).

Persistency of Coverage

Pension coverage only provides meaningful benefits if it persists over time. One study finds that contributors generally persisted in making contributions, but that the contribution rate tended to vary over time. Smith, Johnson, and Muller (2004) use the Survey of Income and Program Participation (SIPP) to look at the persistency of employee contributions to 401(k) plans for up to 12 years. Nineteen percent of contributors were intermittent (i.e., had breaks in their contributions).

Paul Smith (2001), using a sample of tax returns from 1987 to 1996, finds a high rate of drop-off in contributions to Individual Retirement Accounts (IRAs). Of those contributing in 1987, only 45 percent were still contributing in 1992, and 40 percent were contributing through 1996. Sarah Smith (2006), using the British Household Panel Survey, finds a link between pension contributions and changes in an indi-

vidual's income needs, as measured by financial circumstances, health, having a baby, and moving to a new house.

Pension Coverage in Defined Contribution Plans

While coverage is synonymous with participation in defined benefit plans in the United States, in 401(k) plans covered workers generally must also contribute. Not all choose to do so.

To assess progress in improving pension participation, policy analysts need empirical measures of participation. Measures are needed that are consistent with the underlying goal of increasing the amount of retirement income provided through the private pension system. For comparability across plan types, the measure of pension participation for defined contribution plans should be consistent with the measure for defined benefit plans. Concepts that have been developed for defined benefit plans do not always transfer directly to defined contribution plans.

This section discusses the meaning of participation in a defined contribution plan. It presents a measure of active participation that requires that the worker be earning a benefit based on current contributions, made either by himself or by his employer. It compares that measure with a more traditional measure of participation (Turner, Muller, and Verma 2003).

Four definitions of participation in defined contribution plans have been used in empirical studies and reports. First, prior to 2007, an active participant in a defined contribution plan was defined by the Department of Labor in the Form 5500 statistics as a worker with a positive account balance in a defined contribution plan offered through his or her current employer. Total participants include beneficiaries and vested participants who have terminated employment with that employer. Thus, it is possible under this definition for workers and their employers to not be contributing to their defined contribution plan and still be counted as participating in the plan.

Second, as of 2007, the Department of Labor changed its definition of active participants to include any worker who is eligible to participate in a 401(k) plan, whether or not they do so. This definition of active participation is not an economically meaningful definition since it in-

cludes workers who are not participating and thus have zero account balances.

Third, in studies using data from the Current Population Survey (CPS), the Survey of Consumer Finances (SCF), and the Survey of Income and Program Participation (SIPP), workers generally are counted as participating if they respond that they are participating. Thus, the worker decides the definition of pension participation. It is not known what definition or definitions workers are implicitly using when responding that they are pension participants. In defined contribution plans, some workers may mean that they have a defined contribution plan with a positive account balance with their current employer, but others may be basing their response on the more restrictive definition of contributing to their plan.

Fourth, some analysts—for example, Kusko, Poterba, and Wilcox (1998) and Clark and Schieber (1998)—count only those employees contributing to the plan in a given year as participants that year. This definition does not include as participants employees who did not contribute but who had employers that contributed in their behalf. Thus, this definition does not apply to non-401(k)-type plans because employees do not contribute to those plans.

Active Pension Participation

Workers who are enrolled in a defined contribution plan or who have the option to be enrolled, but for whom no contributions are being made, are not participating in a meaningful economic sense. Workers who do not contribute during a year and for whom their employer does not contribute are not considered to be active participants in a defined contribution plan. That definition is consistent with the definition used for defined benefit plans, where workers are participants if they are accruing future benefits. This situation of no contribution being made for a worker who has a plan with an account balance with his or her current employer arises in profit sharing plans, because pension law does not require employers to contribute to those plans every year. It arises in 401(k) plans, where the employer's contribution typically depends on the employee having made a contribution. Also, if an employee makes a hardship withdrawal—for example, for a large medical expenditure—

the employer may temporarily suspend both employer and employee contributions.

One study suggests that nearly 30 percent of workers with 401(k) accounts may not be contributing to those accounts in a given year. The 1993 April CPS asked workers with 401(k) accounts whether they planned to contribute to their accounts, and only 68 percent responded that they did plan to contribute. However, others responded that they did not know whether they would contribute or refused to answer, and for some their employer may have contributed (Honig and Dushi 2003). A more recent study finds that possibly more than 20 percent of participants with a 401(k) account were not active participants because they did not contribute to the account, nor did their employer (Turner, Muller, and Verma 2003). These studies suggest a serious problem affecting the retirement account balances of a substantial number of workers participating in 401(k) plans.

POLICIES TO ENCOURAGE EMPLOYERS TO PROVIDE PENSION PLANS

The employer's willingness to provide pensions in a voluntary system is key. Aspects of pension policy affect the costs that employers face. For example, accounting and regulatory standards can limit employers' flexibility as to the timing of pension contributions, as discussed in the chapter on financing. Standards that limit the maximum amount of overfunding during economic boom periods may force plan sponsors to contribute more during economic slumps, when it is more difficult for them to contribute. Accounting and regulatory standards can limit their flexibility as to choice of portfolio composition. For instance, standards that discouraged plan investments in equity would cause a shift from equities to bonds, which could increase the cost of providing pensions.

With the voluntary approach, pension law does not require employers to provide pensions, and employees are not required to participate. If an employer chooses to provide pension coverage, however, nondiscrimination regulations may require that the employer offer coverage

to most full-time workers. Part-time U.S. workers working less than 1,000 hours a year are excluded from the requirement. Nondiscrimination rules arguably have at least two effects. First, they cause some workers to be covered in firms offering pensions who might otherwise not be covered. Second, they cause some workers not to be covered in firms not offering pensions who might otherwise be covered if the firm could be more selective in its offering. Empirical research is needed to determine which effect predominates.

The voluntary approach to pension participation differs considerably between defined benefit and defined contribution pensions. With a defined benefit pension, if the employer provides a pension to a worker, the worker's participation is automatic. If an employer offers a defined contribution pension, participation by workers may be automatic—and some have proposed that it should be—but generally in 401(k) plans it depends on the worker choosing to contribute.

The economic costs and benefits of pension coverage, and thus the factors affecting whether it is provided by a firm, can be considered at three different locations in the firm's organizational structure.

- First, and the usual focus of analysis, are the tax and other incentives provided to employees to participate in a pension. The incentives provided by government policy create a demand by workers for pension coverage.
- Second, the compensation incentives provided through the pension plan to top management, who are the key decision makers in the firm, may be a factor in whether a firm offers a pension plan. These employees are the top-paid employees in the firm, so the focus is on the incentives provided for pension coverage to highly-paid workers. For example, some proposals would raise the limits on tax-deductible benefits highly compensated workers could receive.
- Third, there are costs and benefits to the firm and its shareholders in terms of how the profitability of the firm is affected by providing pension coverage. For example, firm profitability could be enhanced by its use of the pension to attract and retain talented employees. A firm's decision to offer a pension presumably is based on these three considerations.

Pension Coverage at Small Firms

Pension coverage at small firms is low relative to coverage at large firms, but has risen in recent years (Even and Macpherson 2008). Many small employers do not provide pension plans for their employees. This lack of pension provision may be because their employees place a higher priority on health insurance or on wages than on coverage by a pension plan. Coverage is low in part because workers at small firms tend to have low wages. It may also be low because pensions are more expensive to provide at small firms because of economies of scale.

IRAs

One factor shaping U.S. pension policy is the focus on individual responsibility. With this focus, all workers are covered by a pension plan—the Individual Retirement Account (IRA). They will receive a tax deduction (provided they are liable for taxes) if they contribute to the account.

IRA-Based Plans

One of the approaches that policymakers have taken to encourage employers to offer plans is to provide them with low-cost plan options. There are three IRA-based plan options: 1) the Payroll Deduction IRA, 2) the SEP (Simplified Employee Pension plan), and 3) the SIMPLE (Savings Incentive Match Plan for Employees) IRA. While the Payroll Deduction IRA and the SEP can be set up by any employer, the SIMPLE IRA can only be established by employers with 100 or fewer employees and no other type of pension plan. All three types of plans have no annual filing requirement for the employer. The Payroll Deduction IRA accepts employee contributions only, the SEP accepts employer contributions only, and the SIMPLE accepts both types of contributions. The three types of plans differ considerably in the maximum contributions allowed, which ranged in 2007 from \$4,000 for a Payroll Deduction IRA to \$45,000 for the SEP.

POLICIES TO ENCOURAGE WORKERS TO PARTICIPATE

With a progressive income tax system, under which marginal tax rates rise with worker income, low-income workers have less incentive to participate in a pension plan than do high-income workers. This approach targets incentives to higher-income workers because they have higher marginal tax rates. There is a trade-off between the cost to the government from the tax incentives offered and the amount by which pension participation is increased. Also, there may be a trade-off in a tax-based system between encouraging low-income workers to participate and providing too much in incentives to higher-wage workers, who are more likely to participate in any case.

U.S. employers and policymakers have used a number of approaches to encourage workers to participate in 401(k) plans. These approaches have included increasing the financial incentive for employees to participate, increasing the appeal of pensions through particular features, and making it easier for employees to participate.

First, employers can encourage workers to participate in 401(k) plans by offering a match for employee contributions. The match, for example, could be dollar-for-dollar up to a certain level of employee contributions, with a lower match rate, or no match, beyond that. A number of empirical studies find that employer matching contributions increase employee participation, but the marginal effect on employee contributions of a higher match rate is generally small (Clark and Schieber 1998; Munnell, Sundén, and Taylor 2000; Papke and Poterba 1995).

Second, with automatic enrollment, workers are automatically enrolled in 401(k) plans as the default option; however, workers may choose to not participate. The Internal Revenue Service (IRS) has issued rulings indicating that it is permissible for employers to automatically enroll participants in 401(k) plans provided that the employee is notified in advance and is permitted to leave the plan if he or she chooses to do so (Purcell 2004). With automatic enrollment, part of the participant's pay is contributed to a 401(k) plan and invested in a default investment option without any action required by the worker. Automatic enrollment has been adopted by a minority of plans, but the number is growing. As

of 2004, only 11 percent of all 401(k) plans, and 31 percent of plans with more than 5,000 participants, had adopted automatic enrollment (Profit Sharing/401(k) Council of America 2005). Plans with automatic enrollment tend to be large plans.

Automatic enrollment has been shown to substantially increase pension coverage in studies of a few firms, but the wider applicability of the studies has not been demonstrated. For example, anecdotal evidence suggests that automatic enrollment may have little effect on pension participation during periods of dramatic decline in the stock market. Automatic enrollment is most effective when it makes it easier for people to do something they already wanted to do.

Automatic enrollment might lead to some employees having reduced benefits because they would have participated and contributed at a higher rate than the default rate, but with automatic enrollment they contribute at the default rate. Similarly, efforts to promote the automatic enrollment IRA could lead new or growing firms to choose auto-IRAs, which have no employer match and no ERISA protections for workers, rather than choosing a 401(k) plan.

A problem that may arise with automatic enrollment is lost pensioners. In firms where there is high job turnover, workers may quit without informing the firm, leaving behind small pension amounts in defined contribution plans. These small accounts are vested because of the requirement of immediate vesting of employee contributions, and they can be expensive for employers to maintain.

A British study interviewed employers at 14 firms that had considered implementing automatic enrollment but had rejected the idea (Horack and Wood 2005). It finds that employers were concerned about enrolling workers in plans without their prior knowledge or consent, especially when the workers were required to contribute. They were concerned that such a move would be disadvantageous to some employees. They also were concerned about their increased costs because of the need to make matching contributions for more workers, some of whom would not appreciate the expense to the employer.

Third, participation in 401(k) plans may be encouraged by requiring in a given time frame a decision on whether to enroll in the plan. For example, workers may be required to decide within the first couple of months of work on a new job (Choi, Laibson, and Madrian 2006;

Horack and Wood 2005). Active decisions are best used as the approach to enrolling workers when workers have differing needs and preferences and have a strong propensity to procrastinate. Under standard enrollment, which requires greater initiative by the employee, pension enrollment tends to increase with employee tenure. Active enrollment leads to workers enrolling more quickly and to higher enrollment levels. After three months with active enrollment, the percentage of workers enrolled equaled that which had been achieved previously after three years of standard enrollment. Even after 30 months, for the one firm in the study (Choi, Laibson, and Madrian 2006), participation for employees required to choose still exceeded that of those under the standard enrollment regime, by 83 percent to 69 percent.

Fourth, employers can encourage workers to participate by offering attractive features in their 401(k) plan. For example, offsetting the illiquidity of pension assets by offering loans from a 401(k) plan may encourage participation. In 1997, the General Accounting Office—now called the Government Accountability Office (GAO)—found that participation rates in plans that allowed loans were 6 percentage points higher than in plans that did not allow loans (GAO 1997). One study finds that allowing participant direction of investments increases worker participation (Papke 2004).

A plan design feature adversely affecting participation may be the complexity of the investment decision. One study finds a strong negative relationship between the number of investment options offered by a 401(k) plan and the participation rate. Increasing by 10 the number of funds offered led to a 1.5 to 2.0 percentage point decline in the average participation rate (Huberman, Iyengar, and Jiang 2003).

A UK study, however, finds that simplifying the application form had little effect. In some cases, all the worker had to do was to sign a form that contained information the employer already had obtained from payroll records (Horack and Wood 2005). This approach may have had little effect because workers still faced the problem of how to invest their pension money. Workers with no experience with investments may be reluctant to participate in a 401(k) plan, since they do not know what investments to choose.

Fifth, employers can encourage workers to participate by providing them with financial education about the need for adequate retirement

savings (Bernheim and Garrett 2003; McCarthy and Turner 2000). Although it provides workers with additional information, financial education raises the costs of their plan, which workers may bear through added fees unless paid for directly by the employer.

A sixth possible option is to require married workers who do not participate in the individual account plan offered by their employer to get spousal consent to this decision. A related alternative would be that the spouse would be notified of the decision not to participate. These options, to our knowledge, are untried.

Seventh, an approach that has been discussed in Congress, but not enacted into law, links the pension coverage of executives with rank-and-file workers. It requires employers that provide a pension plan for executives to provide a defined benefit plan for rank-and-file workers.

The voluntary approach to pension participation maintains freedom of choice for individuals and employers. A weakness is that, practically without exception, countries that have used this approach have not raised pension coverage above 50 percent for private sector workers. With this approach, coverage rates tend to be relatively low among low-wage workers (Hinz and Turner 1998). Because tax incentives are provided by exempting contributions and investment earnings from income taxation, this approach offers greater incentives to higher-income workers than lower-income workers in a progressive income tax system because higher-income workers have higher marginal tax rates (Reagan and Turner 2000).

Within the voluntary approach, a relatively high degree of compulsion (incentive) would be achieved if employers offering a pension were required to cover all workers, if benefits were locked in until retirement, and if tax credits were offered. A relatively low degree of compulsion (incentive) would be achieved if the marginal tax rates workers faced were low, if the amounts that could be contributed were low, and if the tax treatment was relatively unfavorable—for example, by employee contributions not being tax-exempt.

Pension Coverage for Low-Wage Workers

In the United States and other countries with voluntary pension systems, the participation rate is considerably higher for high-income

workers than for low-income workers. The participation rate in the United States was higher than 75 percent for groups with income higher than \$80,000 a year in 1997, while it was only 22 percent for those workers with annual income under \$20,000 (CBO 2003). Because, in a voluntary pension system, coverage rates tend to be lower for low-wage workers than for high-wage workers, this section focuses on efforts to raise the pension coverage rate for low-wage workers.

These efforts may be limited, without a subsidy, by concerns over reducing the already low wages of low-wage workers. Because of the pension-wage trade-off, providing pensions for low-wage workers would presumably result in a reduction in their wages. In any case, coverage is already available to all U.S. workers because they can contribute to an Individual Retirement Account (IRA), though few do.

Unions can play an important role in the coverage of low-wage workers. One study finds that while 34 percent of low-wage men were covered by a pension, 71 percent of low-wage men who were union members were covered by a pension (Ghilarducci and Lee 2005).

Within the basic voluntary framework of tax preferences for pensions, other policies can further encourage low-wage workers to participate. Small businesses can claim a tax credit for certain costs of starting a new plan for their employees. Low-wage workers work disproportionately at small businesses, and small businesses are more likely than large businesses to not provide pensions.

Tax preferences provide minimal incentives to the majority of American households—those who are in the 15 percent, 10 percent, or zero income tax brackets. The Saver's Credit, enacted in 2001, was designed to address this problem. Eligible moderate- and lower-income employees may be able to claim a tax credit for half of their pension contributions up to a maximum credit of \$1,000 through the Saver's Credit for contributions to a retirement plan starting in 2002. As the only major pension tax incentive targeted specifically to the majority of American households, it was designed to level the playing field in terms of tax incentives received by upper- and lower-income taxpayers by giving taxpayers earning less than \$50,000 a tax credit for contributions to 401(k) plans, IRAs, and similar retirement savings plans. The Pension Protection Act of 2006 made it permanent and indexed its income eligibility limits to inflation. Because the Saver's Credit is nonrefund-

able, it merely offsets a taxpayer's tax liability; it provides no saving incentive for about 50 million lower-income households that have no income tax liability.

Automatic enrollment is another policy to encourage low-wage workers to participate. Once they are automatically enrolled, inertia may keep them enrolled, though this effect has not been investigated over more than a few years. Furthermore, its effects may be undone at job change if workers withdraw their account balances. The positive effect on retirement savings may be short-lived, with workers cashing it out when they change jobs.

Coverage of Nonworking Spouses

Pension participation is generally limited to workers. However, workers are permitted to establish an Individual Retirement Account (IRA) for a nonworking spouse. This option is not available through 401(k) plans but would be a possible extension. In Sweden, the mandatory Premium Pension Plan permits a worker to contribute to the account of a spouse. Pension participation could be extended further to nonworkers by permitting anyone with income to establish a pension account, or even by permitting a pension account to be established for anyone—even for those without income. The account could be established, for example, by parents of nonworking or disabled children.

Participation in 401(k) Plans

One of the surprises of pension policy during the 1990s was that some workers do not contribute to a 401(k) plan even though their employer offers a matching contribution. It was thought that the matching contribution, on top of the tax incentive, would provide a powerful incentive. At least five reasons may explain noncontribution, and thus nonparticipation, by workers eligible to participate in a 401(k) plan (Turner and Verma 2007). The first is the traditional economic reason of lack of economic incentives to participate. In addition to that reason, four reasons apply to workers who do not fit the classic definition of being well-informed and rational:

- 1) high discount rates causing them to place little value on future consumption,
- 2) lack of information as to the economic benefits of participating in a pension plan,
- 3) lack of willpower to follow through on a decision, and
- 4) failure to make a decision because of passivity, ambivalence, or inertia.

Understanding the different reasons for nonparticipation by workers may aid in developing effective policies that would help workers achieve good pension outcomes.

The term “high discount rates” refers to the time discounting of future consumption by workers. If workers place a low value on future consumption relative to present consumption, they are less likely to save, including by participating in a pension plan. Some workers may not participate in a plan because they lack information about the plan, or perhaps they lack information about the need to save for retirement. Some workers may understand the need to save, but they are unable to discipline themselves when faced with the temptations of current consumption. Other workers may not register for coverage when coverage is not automatic because they have ambivalent feelings, because they mistrust financial institutions, or because they have a passive attitude toward this type of decision making.

Research in behavioral finance has provided lessons for plan design that may raise participation in 401(k) plans. Behavioral finance considers psychological issues affecting how workers make financial decisions. An insight from behavioral finance is the importance of defaults. Judicious choice of defaults by pension plan sponsors, so that coverage is the default option, may have the result that workers are more likely to have pension coverage.

Coverage Insights from Behavioral Economics and Behavioral Finance

An assumption underlying the system of voluntary employee participation in defined contribution plans is that individuals make good financial decisions that they are able to implement. The reality is that

many individuals are passive, accepting the default, or make poor choices, resulting in retirement income that is insufficient to maintain their preretirement living standards. Behavioral finance theorists have used their insight into the roles that inertia and procrastination play in worker behavior to propose solutions that preserve worker choice while arguably achieving better long-run outcomes for many workers.

Behavioral finance and behavioral economics focus on psychological factors affecting individuals' decision making. These factors include how individuals deal with problems arising from the quantity and quality of information available to them. This approach expands on the methodology of traditional finance and economics, which focuses on the behavior of well-informed persons who are psychologically capable of implementing the decisions they make.

Encouraging Participation

The most commonly used arrangement for enrolling workers in 401(k) plans, called "standard enrollment," is that workers must sign up to participate. The default if the worker takes no action is nonparticipation. The worker who participates must choose how much to contribute, whether to change the contribution rate over time, and the asset allocation for his or her account.

Some workers whose employer offers a 401(k) plan may not participate in it because they are ineligible or because they do not choose to participate. Data from the Survey of Income and Program Participation (SIPP) for 2003 indicate that those who are eligible but do not participate constitute 22 percent of private sector workers eligible to participate in defined contribution plans (Turner and Verma 2005). Employees who work in firms that offer 401(k) plans but who do not participate in any plan offered by their employer tend to be younger than participants, to be female, and to have lower education, earnings, and tenure (Hinz and Turner 1998; Turner and Verma 2005).

Economic studies of pension participation (Hinz, Turner, and Fernandez 1994) indicate characteristics of workers who do not participate when offered a pension plan. They generally do not examine the workers' reasons for why they do not participate. For example, it is unclear whether workers' nonparticipation reflects an affirmative choice

made by them or reflects inertia which has caused them not to make an active choice. Furthermore, inertia could be caused by different factors—indecisiveness, lack of interest, or inability to act on a decision.

The Survey of Income and Program Participation (SIPP) for 2003 asked nonparticipating workers who were offered a pension why they did not participate (Table 3.1). More than 40 percent of nonparticipating men and nearly 40 percent of women replied that they could not afford to contribute. Roughly 20 percent of nonparticipating men and nearly 30 percent of women indicated that they did not want to tie up the money. The next most common reason given by both men and women (more than 14 percent of each not participating) was that they hadn't thought about it. Other responses included that the worker did not need the plan, or that the worker or spouse had other pension coverage. With this set of questions, most participants gave economic, rather than behavioral, reasons for not participating—they couldn't afford to, they didn't want to tie up their money, or they didn't need the coverage.

These responses can be compared to those from an earlier study of federal government workers who did not choose to participate in the Thrift Savings Plan (Hinz and Turner 1998). The Thrift Savings Plan

Table 3.1 Reasons Why Workers Who Are Eligible to Participate in a Pension Plan Do Not Participate (%)

Reasons for not contributing	Men	Women
Cannot afford to contribute	43.6	39.7
Do not want to tie up money	21.6	28.8
Haven't thought about it	14.4	14.5
Do not plan to be on job long enough	7.2	4.6
Have an IRA or other pension coverage	4.6	4.6
Spouse has a pension plan	4.2	1.4
Employer doesn't contribute or doesn't contribute enough	3.7	4.2
Do not need it	3.6	3.5
Started job too close to retirement	2.3	1.2
Some other reason	23.2	25.6

NOTE: Figures represent percentage of noncontributing eligible workers. Percentages sum to more than 100 because workers can provide multiple answers.

SOURCE: 2003 SIPP data set (Turner and Verma 2005).

Table 3.2 Reasons for Not Contributing to the Federal Thrift Savings Plan (%)

Reasons for not contributing	Men	Women
Can't spare the money	28.7	34.2
Prefer other investments	24.2	19.7
Too close to retirement	16.7	13.1
Don't understand the Thrift Savings Plan	13.7	16.0
Don't want money tied up	14.2	14.2
Don't have enough information	12.0	14.5
No confidence in the plan	10.3	5.8
Haven't considered the Thrift Savings Plan	10.1	9.6
Never got around to it	7.3	13.7
May not stay in federal government	3.9	3.8

NOTE: Figures represent percentage of noncontributing eligible workers; multiple responses were possible.

SOURCE: Hinz and Turner (1998); computations from 1990 Federal Retirement Thrift Investment Board data.

was designed to be similar to 401(k) plans. The most common answer, given by more than a fourth of men (29 percent) and a third of women (34 percent), was that they could not afford to contribute (Table 3.2). However, factors other than income were clearly among the determinants of the response that the worker could not afford to contribute. Most (81 percent) of the workers in the lowest income quartile did not give that response, while a few (7 percent) of the workers in the highest quartile did give that response.

The SIPP data give two possible responses for not contributing that may relate to noneconomic reasons (“Haven’t thought about it” and “Some other reason”). In contrast, the data used in the Hinz and Turner (1998) study provide a number of noneconomic reasons as options. Nearly one in six men and women (16 percent of each) did not contribute to the Thrift Savings Plan because, they reported, they did not understand the plan, and nearly as many (12 percent of men and 15 percent of women) did not contribute because, they reported, they did not have enough information. A tenth of the noncontributors (10 percent each of men and women) did not contribute because they had not considered whether to do so. More than one-eighth of women (14

percent), but fewer men (7 percent), did not contribute because, as they reported, they had not bothered to sign up to do so.

Information problems. How much workers and their spouses should save for retirement is a complex problem. The answer depends on factors such as the age at which they started saving for retirement, their expected age at retirement and what their life expectancy is at that age, the expected rate of return and risk associated with their investments, whether they have employer-provided retiree health insurance, and whether they own their home and expect to have paid off the mortgage by retirement. Some workers may not participate in a pension plan because they do not understand how much they need to save for retirement or the consequences of saving inadequately. Some may not participate because they find pensions too complex to feel comfortable making that decision, especially since it involves substantial sums of money.

Undersaving for retirement may occur because some workers underestimate their life expectancy. They may do so because they are unaware of how quickly life expectancy is improving, basing their own life expectancy on that of their older relatives. Thus, “demographic literacy” as well as “financial literacy” may be a source of problems in individuals’ planning for retirement.

A study by the Society of Actuaries (2004) finds that a majority (67 percent of preretirees) of the male respondents underestimated the life expectancy of the average 65-year-old man. Of that group, 42 percent underestimated average life expectancy by five years or more. Roughly half (54 percent) of preretiree females underestimated the life expectancy of the average 65-year-old woman. A British study finds that on average people over a range of ages underestimated their life expectancy by 4.6 years for males and 6.0 years for females. Males ages 30 to 39, an age range where they may be considering seeking employment that provides pension coverage, underestimated their life expectancy by 6.3 years, while females in that age range underestimated their life expectancy by 6.5 years (O’Brien, Fenn, and Diacon 2005). These findings suggest that a substantial part of the population may considerably underestimate its life expectancy, which could be a cause of undersaving for retirement.

Choice of defaults. If all workers actively made wise decisions concerning their pension participation, defaults in designing 401(k) plans would be irrelevant. However, some workers do not make a choice and are automatically placed in the status determined by the default. Defaults may have a socially desirable function when they can be structured so that workers end up in a situation that increases their retirement savings.

Evidence from U.S. studies suggests that automatic enrollment may be a more successful way to increase pension coverage than employer matching contributions. For example, Madrian and Shea (2001) find that automatic enrollment led to substantially higher enrollment among new employees in one firm than a system that relied solely on offering a match. Choi, Laibson, and Madrian (2004), using data for three firms, find that automatic enrollment had its largest effect on participation at short job tenure, but after three years of tenure, the participation rate among employees hired under automatic enrollment was still 30 percentage points higher than among employees hired under standard enrollment with the same tenure.

For workers who are uncertain about how to invest, automatic enrollment has the advantage that the investment choice is made by default. A British study suggests that automatic enrollment is successful in part because some workers who do not choose to participate are intimidated by the choice of investments (Horack and Wood 2005).

These studies have been based on a small number of large firms that have been innovators in how they provide benefits. The experience in these firms may not be typical of that across the U.S. labor market, especially in smaller firms and in firms with predominantly low-wage workforces. The extent to which the results can be generalized to the entire private sector workforce has not been assessed.

Some changes have been made in federal law to encourage automatic enrollment. The Pension Protection Act of 2006 clarified that federal law in this area preempts state law. In addition, federal law could be changed so that employees who were automatically enrolled but accumulated only small amounts and wished to withdraw the funds from their accounts could do so without penalty. To increase the incentive for firms to offer automatic enrollment, Congress could limit the current safe harbor rules concerning antidiscrimination to only those plans that

offer automatic enrollment and automatic increases in contributions, so as to assure that workers taking the default are contributing a sufficient amount (Gale, Iwry, and Orszag 2005).

Other factors affect workers' decisions to participate. For example, several studies find that workers covered by a defined benefit plan provided by their employer are less likely to participate in a 401(k) plan the employer provides than workers who are not covered by a defined benefit plan (Andrews 1992, Bernheim and Garrett 2003). Since the early 1980s, roughly 15 percent of the private sector wage and salaried workforce has been covered by both a defined benefit and a defined contribution plan (USDOL 2005a).

CONCLUSION

Several 401(k) policy options could encourage workers to participate. Many of the ideas discussed here have resulted from developments in behavioral finance and relate to the choice of defaults. Studies suggest that the choice of defaults can have a large effect on workers' behavior, and that the judicious choice of defaults may ultimately lead to workers' having larger 401(k) plan account balances at retirement. However, these studies have been done for only a few large firms and may not be generalizable to small firms. The findings also may not be generalizable to periods when the stock market is falling. Further, its effect appears to dissipate over time, and may be undone at job change by workers' withdrawing money from their accounts.

Traditionally, the default for workers unable to decide whether to participate in a 401(k) plan has been nonparticipation. However, some plan sponsors have established defaults that preserve freedom of choice for workers wishing to make a choice but that result in good decisions for workers who are uncertain as to what to do. These defaults start with automatic enrollment in the plan unless workers affirmatively decide to not participate.

Automatic enrollment creates problems of inadequate buildup of assets if the default contribution rate is low and the default investment is highly conservative. Thus, some firms have established a default contri-

bution rate that starts low but gradually increases over a period of years. Some firms have made the default investment a life-cycle fund, where the default investment is more heavily weighted to stocks for younger workers but gradually shifts towards bonds as workers' expected retirement approaches. If workers change jobs, the default in some 401(k) plans is that the plan assets are rolled over into an IRA.

While defaults may not be optimal for all workers, such as short-tenure workers, in a 401(k) plan they help assure that more workers will accumulate assets that are available to finance retirement consumption. The effects of the defaults on women, minorities, and low-wage workers, in particular, deserve further attention.

